Washington Post, January 13, 2011

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The fight between big banks and investors who lost a fortune on mortgage-backed securities is shifting from private litigation to the public arena.

The change in strategy comes as the number of foreclosures continues to skyrocket. Banks repossessed 1 million homes in 2010, and the number is expected to increase this year.

While the investors have been angry at the banks for several years for the losses, their legal efforts have not gotten far, mostly because of the difficulty of organizing enough peers for class-action lawsuits and of prying information from the lenders. But the recent uproar over the banks' foreclosure practices has given the investors a way to pressure lenders outside the courts.

As Congress begins discussing potential mortgage servicing legislation, and as the group of 50 state attorneys general investigating problems with foreclosures continues to hammer out details of a settlement with the banks, the investors find themselves fortuitously aligned with borrowers who are facing foreclosure and who have the sympathy of lawmakers.

The Association of Mortgage Investors, a Washington-based group that represents hedge funds, state pension funds, charitable endowments and other investors, on Wednesday fired the latest salvo by issuing a "white paper" that delineated its views on what would constitute an acceptable settlement between the banks and the state attorneys general. The investor group is calling for improvements to servicing and transparency that the banks have resisted in the past.

"We're focused on developing real solutions to sort out the housing finance market and broken servicing model in an equitable fashion for responsible borrowers, distressed homeowners, mortgage servicers and the mortgage investors," said Chris Katopis, executive director of the group.

The team leading the 50-state investigation has been meeting with the country's major servicers in recent weeks and with stakeholders such as the investors. The negotiations seem to be leading to separate but similar deals with each big mortgage firm, according to industry and state sources. A final settlement may be a few months away. Iowa Assistant Attorney General Patrick Madigan declined to comment on the details of the talks but said, "We continue to work hard on this complicated issue, but there is no imminent settlement at this time."

In Congress, lawmakers such as Rep. Brad Miller (D-N.C.) have been in close contact with consumer groups that represent borrowers and with the investors, because of their shared interest in mortgage reform. "Some unlikely allies are now talking and working more together to fix the problems," he said.

Miller said he plans to reintroduce legislation that could force banks to spin off their mortgage servicing operations, but he added that he's not overly optimistic it will pass, given the new Republican majority in the House. He said he is putting more hope in pushing regulators to use their new powers under the Dodd-Frank financial regulatory law to bring changes to bank foreclosure practices.

Investors represent what may be the biggest risk to banks that initiated questionable foreclosures. While homeowners may succeed at getting individual foreclosures delayed or even overturned because of paperwork mistakes and other errors, the money at stake in such cases is minuscule compared with the billions in bad mortgages that banks could be forced to buy back if investor lawsuits are successful. One estimate by J.P. Morgan Chase put the price tag at $120 billion.

The pressure from mortgage investors comes just weeks before the release of two key federal reports about the mortgage industry - a multi-agency report on the foreclosure problems and another by the Treasury Department on Fannie Mae and Freddie Mac.

Meanwhile, home foreclosure filings dropped 26 percent in December from the same time a year ago, the biggest annual drop since RealtyTrac started tracking the figures in January 2005.

The slowdown is not a sign of a strengthening housing sector, according to the California-based firm, which sells foreclosure data. Rather, it's a consequence of the temporary halt in evictions adopted by some major lenders after widespread reports of foreclosure paperwork errors.

"There's nothing to suggest that this is a market-driven improvement, especially with that big a decrease," said Daren Blomquist, a RealtyTrac spokesman.

The company reported that 257,747 homes were in some stage of foreclosure in December, the lowest monthly total since June 2008. Foreclosure filings in December dropped 2 percent from the previous month, when the effects of the foreclosure moratorium started to surface in RealtyTrac's data.

"Even so, 2010 foreclosure activity still hit a record high for our report, and many of the foreclosure proceedings that were stopped in late 2010 - which we estimate may be as high as a quarter million - will likely be re-started and add to the numbers in early 2011," James J. Saccacio, RealtyTrac's chief executive, said in a statement.

Despite the expected rise in foreclosures for 2011, a key federal program to help delinquent borrowers avoid foreclosure has continued to show disappointing results, the Government Accountability Office reported Wednesday.

In early 2009, the Treasury Department announced that the Home Affordable Mortgage Program would help 3 million to 4 million homeowners by reducing their monthly payments to affordable levels, but through the end of November, fewer than 550,000 permanent loan modifications had begun, the GAO said.

The number of started trial modifications declined from about 118,000 in December 2009 to about 31,000 in November, and fewer than half of the modifications begun on a trial basis have led to permanent modifications, the GAO reported.

Treasury spokeswoman Andrea Risotto said the program has had a positive effect.

"HAMP has spurred the industry to take additional actions to help struggling homeowners," she said via e-mail.

Daily Staff writer David S. Hilzenrath contributed to this report.